come of the group. Section 234 (a) provides that "in computing the net income of a corporation subject to the tax" (i. e., of a "taxpayer") these deductions shall be allowed. No provision in terms requires or permits that they shall be allowed in computing the net income of an affiliated group or the net income of any other taxpayer (and every other member of the group is a separate, distinct "taxpayer"), yet the deductions are so allowed, and must be, in order to give effect to the "consolidated returns" provisions of Section 240.

The Treasury Department concedes the correctness of the foregoing with respect to all deductions allowed by the Act to each member of the group, with the sole exception of the "net loss" deduction allowed in Section 206. And yet the Act draws no distinction, as to rank, degree or extent, between the so-called ordinary deductions allowed in Section 234 and the "net loss" deduction. Section 232 defines net income of a corporation as "gross income as defined in Section 233, *less the deductions allowed by Sections 234 and 206.*" This would seem to dispose of the question if "words mean what they say, and not the opposite," as the court below insisted on excellent authority, but the Treasury Department contends for, and the court below sustained, a distorted, strained interpretation of the Act on the claimed ground that otherwise an unjust result would be reached which the Congress could not have intended. When considering the Treasury Department's request thus to rewrite a statute to conform with its, or even the Court's, ideas of how the statute should have been written, this Court will not overlook the salutary rule announced by Mr. Justice Cardozo, writing as Chief Judge of the New York Court of Appeals, in *People ex rel. Studebaker Corporation* v. *Gilchrist,* 244 N. Y. 114, at pages 125 and 126, that:

> "The taxing officers of the State are mere administrative agents. They may not devise new

> forms and methods of taxation, however convenient or useful. * * * If one method of assessment or collection is pointed out, the courts will not permit the application of another on the theory that the Legislature might just as well have chosen it, * * *."

As this Court said in *United States* v. *Goldenberg*, 168 U. S. 95, 102:

> "The primary and general rule of statutory construction is that the intent of the lawmaker is to be found in the language that he has used. He is presumed to know the meaning of words and the rules of grammar. The courts have no function of legislation, and simply seek to ascertain the will of the legislator."

The Treasury Department first objects that if a net loss of one corporation should be allowed as a deduction in computing consolidated net income of an affiliated group, in excess of the net income (computed without regard to such net loss) of the particular corporation sustaining the net loss, the benefit of the deduction, to the extent of the excess, would be given to other "taxpayers", whereas the Act gives the benefit only to *the taxpayer*. But it must be apparent that this objection applies with equal force to the deductions allowed by Section 234, which, also, are allowable only in computing the net income of *the taxpayer*, and yet the excess of the interest and taxes (for instance) paid by one member over its gross income is concededly allowable to reduce the taxable income of the group or the other members thereof. This was the deliberate intention of the Congress in providing for consolidated returns, i. e., to tax "as a business unit what in reality is a business unit" (Cong. Record, Vol. 57, Part I, p. 255).

The Act itself recognizes that, unless specifically limited, every deduction, credit and exemption allowed to

each member of the group must be taken into account in computing the tax on a consolidated return. Section 236 (b) allows every corporation, whose net income is $25,000. or less, a credit of $2,000., and since it was not desired that each member of an affiliated group have such a credit, Section 240 (b) expressly provides that only one such credit shall be allowed on a consolidated return.

The Treasury Department next objects that since the net loss deduction is allowable only in computing "net income" (which, it is contended, means net income of the particular taxpayer corporation) and since "net income" always must be a positive figure, the net loss deduction cannot be allowed to an amount greater than sufficient to reduce the particular corporation's net income to zero.

In the first place, we point out that this objection, also, applies equally to the ordinary deductions since they, too, are allowable only "in computing net income" and yet we have seen that so to limit the allowance of the ordinary deductions would nullify to a large extent the result intended to flow from consolidated returns, and we also know that the Department has never attempted so to limit them.

Secondly, and for the same reason, we submit that, under the general scheme of the law, the "net income", in the computation of which a deduction is allowed *on a consolidated return,* must mean *consolidated net income.*

Thirdly, we urge that there is no justification for saying that "net income" must always be a positive figure. "Net income" as used in the Act is a term of art, defined in effect as "gross income" less certain deductions (which, as pointed out above, include the net loss deduction). The result in every case is "net income" whether it be plus or minus, black or red. The Treasury Department urges that it is inadmissible so to construe the term because, it is claimed, where the result is minus it is not "net income" but "net loss" and a net loss cannot

be used to produce or increase a net loss. But "net loss", also, is a term of art. It does not mean "gross income" less "deductions", in cases where, perchance, the result is minus, but it is defined in Section 206 (a) as the excess of the ordinary "deductions allowed by Section 234" (not including, be it noted, the net loss deduction allowed by Section 206) over gross income, "with the following exceptions and limitations" specifically set out.*

The former Secretary of the Treasury himself has recognized this obvious point, that "net income" may be either a positive or a negative quantity. In a statement published in the Internal Revenue News (Vol. 2, No. 8, p. 17—February 1929) in explaining the new Regulations under the Revenue Act of 1928, Mr. Mellon stated that:

> "The net income of the affiliated group is, in effect, the *algebraic* sum of the net incomes of the separate corporations in the group * * *." (Italics supplied.)

Mr. Mellon must have used the adjective, "algebraic", intentionally. Its well defined meaning shows that he considered that "net income" might be either a positive or a negative figure (Webster's International Dictionary, "algebraical"), and, as we have stated above, the Treasury Department concedes that consolidated net income is made up, in effect, of the algebraic addition of the positive and negative "net incomes" of the members of the group where any such negative net income results from an excess of the ordinary deductions allowed in Section 234 over the gross income. What the Department's contention really amounts to is that a negative net income cannot be produced or increased by a net loss deduction and yet the Act draws no distinction between the treat-

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*Section 117 (a) (6) of the Revenue Act of 1928 expressly provides that a prior year's net loss shall not be allowed as a deduction in computing a net loss, but this was necessary because the definition of net loss in the 1928 Act is "the excess of the deductions allowed *by this title* over the gross income, with the following exceptions and limitations:".

ment of net loss deductions and other deductions in computing "net income", although such a distinction is drawn in connection with the computation of a "net loss", in that the Act deliberately excludes "net losses" from the deductions allowable in computing "net losses".

Further confirmation of the soundness of the foregoing is found in Section 206 (b) of the Act. The net loss for the first year is allowed as a deduction in computing net income for the second year, but it is provided expressly that if such net loss is in excess of such net income "computed without such deduction", such excess shall be allowed as a deduction in computing net income for the third year. It is because of this express limitation that a net loss is not allowable in the second year, in excess of the second year's net income computed without the net loss deduction—otherwise the entire amount would be allowable in the second year. Since the full allowance of it in the second year in such cases would not benefit the taxpayer (because a net loss for one year cannot produce or increase a net loss for another year), Congress desired to preserve the benefit of such excess for the third year, and it was recognized that an express limitation was required in order to prevent the allowance of the full net loss in the second year, where it would yield no benefit, except possibly, but not necessarily, in cases of consolidated returns.*

Whether or not, in order to tax "as a business unit what in reality is a business unit" and in order fully to harmonize the consolidated returns provisions with the net loss provisions, this express limitation as to the sec-

* Strictly speaking, the law does not thus limit the net loss deduction as to the second year. The full amount of the loss is allowable "in computing net income" of the second year, *and* (also) the excess of the net loss over the second year's net income is allowed again as a deduction in computing the third year's net income. Since the net loss is allowed merely in computing the second year's *net income*, and is not allowable in computing a *net loss* for the second year, such double deduction is not unfair. Although, technically, the net loss deduction thus may be allowed twice (in part), the taxpayer benefits from it but once, partly in one year and partly in another.

ond year should be construed, in cases of consolidated returns, as applying only where the net losses of all member corporations exceed the consolidated net income for the second year, *rather than where the net loss of each member exceeds the net income of that member for the second year*, is of no importance here, since, regardless of the correct answer to that question, the net loss for 1925 (the first year) is clearly allowable in full in computing net income for 1927 (the third year) which is the year in issue, because the Act imposes no such limitation with respect to the third year, but as to the third year the net loss is allowable in full, in the same manner and to the same extent as any other deduction. That question does, however, affect the right to deduct the net loss for 1926 (again the first year) in computing the net income for 1927 (in this instance, the second year), to the extent necessary to reduce 1927 consolidated net income to zero, but in this case the allowance of the 1925 net loss alone will have reduced the 1927 consolidated net income to below zero.

POINT II.

The effect of Respondent's position on cases where the corporations were affiliated for all three years.

One further consideration of utmost importance remains to be discussed. The position of the Treasury Department in this case is not based on the fact that the net losses were sustained in years during which the Piedmont Savings Company was not affiliated with Petitioner, although the court below apparently considered that the most important feature of the case and based its decision principally on the ground that

> "a ruling which permits a corporation, with a consistent record of gains, to affiliate with one having

> a large accumulation of statutory net losses for the purpose and with the result of using these losses in the year of affiliation * * * appears generally inappropriate to the federal scheme of income taxation * * *."

The Treasury Department's views as to this phase of the case are significant. The Department first conceded that a net loss prior to affiliation may be deducted on a consolidated return for a later year, and although this deduction was limited, as to the second year, to the amount of the net income of the particular corporation which sustained the net loss, no such limitation was applied as to the third year. (Solicitor's Law Opinion 1113, Par. 4, III-2 Internal Revenue Cumulative Bulletin 36, p. 41). In General Counsel's Memorandum 3266, VII-1 C. B. 205, the Department extended this limitation (to the amount of the net income of the particular corporation which sustained the net loss) to the third year, under the Revenue Act of 1921, in which net income was defined as constituting gross income less only the ordinary deductions allowed by Section 234.

Subsequently, the Department, following the erroneous opinion of the Board of Tax Appeals in *The Sweets Company of America* v. *Commissioner,* 12 B. T. A. 1285, took the position that where a consolidated return is filed the consolidated group itself is the "taxpayer" and that where the composition of the group changes between the year in which the net loss was sustained and the year in which its benefit is claimed, the deduction cannot be allowed because the Act allows the deduction only to the "taxpayer" which sustained the net loss. (This view was expressed in the Government's briefs filed in a number of cases and in its unpublished rulings issued in a great many specific cases.)

After the erroneous views of the Board of Tax Appeals were disapproved on appeal by the Second Circuit

Court of Appeals (40 Fed. (2d) 436) and by the Court of Claims in *Swift & Company* v. *U. S., supra,* the Department again conceded, and still concedes, that a net loss prior to affiliation may be deducted on a consolidated return for a later year, but the Department now limits this deduction, not only as to the second year but also as to the third year, to the amount of the net income of the particular corporation which sustained the net loss, even under the Revenue Acts of 1924 and 1926, both of which define net income as gross income *less the ordinary deductions and the net loss deduction.* (General Counsel's Memorandum 8618, IX-2 C. B. 180.) We have shown that there is no justification for such a limitation on the allowance of the net loss deduction, particularly as to the third year.*

The Department would apply this limitation to cases where the affiliated group had existed unchanged throughout all three years (General Counsel's Memorandum 8132, IX-1 C. B. 287), and the court below probably would sustain it (*Planters' Cotton Oil Co.* v. *Hopkins,* 53 Fed. (2d) 825). It is in cases of that class that the Department's theory reaches the most preposterous result and works the greatest injustice. An excellent example of how the Department's theory affects such cases may be found in the following hypothetical case which, except for immaterial variations, is on all fours with the actual situation of the Utah Fuel Company, on behalf of which this brief is filed.

Company A owns in its own right and operates certain coal mines. Since the inception of the income tax laws Company A has owned the entire capital stock of

* Article 41 (c) of Regulations 75, applicable to 1929 and later years, which have the force of law under the Revenue Act of 1928, expressly recognizes the right to deduct a net loss prior to affiliation, without limiting the deduction, as to either the second or third year, to the amount of the particular corporation's net income during affiliation, although an entirely new limitation (based on the amount paid for the stock of the corporation which sustained the net loss) is imported for the first time, but only as to 1929 and later years, and this new limitation was designed expressly to cure the above quoted objection of the court below.

Company B, which owns and operates other coal mines in the same area. These companies have always filed consolidated returns. Their business, consisting of the mining and selling of coal, has always been conducted as one unit—in fact, the operations of Company B have been conducted as a mere branch or department of the business. In 1924 an explosion occurred in one of the mines belonging to Company B, as a result of which Company B sustained a net loss for that year, computed separately, of $1,000,000. Company A had a net income for that year, computed separately, of $400,000. The consolidated return, therefore, showed a consolidated net loss of $600,000., all of which was attributable and allocable to Company B, under the regulations of the Commissioner of Internal Revenue. Therefore, Company B (a taxpayer) sustained a net loss for 1924 of $600,000.

For 1925 and also for 1926 Company B had a loss or a minus net income, computed separately, of $100,000., due also to the 1924 explosion. For each of those years, Company A had a net income, computed separately, of $600,000. The consolidated net income for each of those years (without taking any net loss into consideration) was, therefore, $500,000.

In such a case, the Commissioner would refuse to allow any part of Company B's 1924 net loss as a deduction in computing consolidated net income of the group for either 1925 or 1926, (although Regulations 75 expressly require the allowance as to 1929 and later years), and he would base his decision upon the same grounds relied upon by Respondent in this case, i. e., that the benefit of the net loss is allowable only to the taxpayer which sustained it and not to any other member of the affiliated group; that a net loss is allowable only in computing net income; that net income must always be a positive, and can never be a negative, quantity; that Company B had no net income of a positive

quantity for either 1925 or 1926; and that for these reasons no part of the 1924 net loss would be allowable in either 1925 or 1926.

It is respectfully submitted that an application of the Act which produces such a harsh result subordinates the "consolidated returns" provisions, even sacrifices them, to a strained interpretation of the "net loss" provisions, rather than harmonizing these two component parts of a single taxing statute in a manner which gives full effect to the spirit and intent of both parts without doing violence to the literal language of either. It certainly nullifies the scheme of "taxing as a business unit what in reality is a business unit" which was the *raison d'etre* of the consolidated returns provisions.

Respectfully submitted,

ROLLIN BROWNE,
Amicus Curiae.

TAYLOR, BLANC, CAPRON & MARSH,
Of Counsel.

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